DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS NUMBER: 05-0195
Adjusted Gross Income Tax
For the Years 1999-2002

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ISSUES

I. Adjusted Gross Income Tax—Eligibility for inclusion in a consolidated return.

Authority: Ind. Code § 6-3-2-2; Ind. Code § 6-3-2-2.8; Ind. Code § 6-3-3-2.; Ind. Code § 6-3-4-14; Ind. Code § 6-3-8-2; Ind. Code § 27-1-18-2; *Associated Insurance Co. v. Indiana Dep't of State Revenue,* 655 N.E.2d 1271 (Ind. Tax 1995)

Taxpayer protests the disallowance of a life insurance company from its consolidated group for adjusted gross income tax and supplemental net income tax purposes.

II. Adjusted Gross Income Tax—Computation of research expense credit

Authority: Ind. Code § 6-3.1-4-2; Ind. Code § 6-3.1-4-4; I.R.C § 41; I.R.C. § 1501

Taxpayer protests the disallowance of its method of computing the credit for research expenses.

III. Adjusted Gross Income Tax—Inclusion of subsidiary in a consolidated return.

Authority: 45 IAC 3.1-1-38

Taxpayer protests the exclusion of a subsidiary from its consolidated income tax return.

IV. Tax Administration--Penalty

Authority: Ind. Code § 6-8.1-10-2.1; 45 IAC 15-11-2.

Taxpayer protests the imposition of the ten percent (10%) penalty for negligence.

STATEMENT OF FACTS

Taxpayer is a holding company for a group of corporations engaged in a myriad of different industries. One of the corporations in Taxpayer's group for federal income tax purposes is a domestic life insurance company. During the years in question, Taxpayer filed consolidated returns including several corporations, including the life insurance company.

As a result of Department audit, the non-insurance subsidiaries and the life insurance company were effectively separated for adjusted gross income tax and supplemental net income tax purposes. This had the effect of increasing Taxpayer's total tax due for the years in question.

In addition, various subsidiaries of Taxpayer engaged in activities that resulted in eligibility for a research and development credit. When computing the percentage of the credit apportioned to Indiana, Taxpayer initially used the percentage based on its consolidated group's apportionment factor. However, Taxpayer amended its returns to divide its credit pro rata among its eligible subsidiaries, then used the apportionment factor for each separate company to compute its allowable credit. The Department disallowed Taxpayer's approach used in its amended returns.

Further, for the years in question, Taxpayer did not initially include one subsidiary on its initial tax returns. Upon audit, Taxpayer sought to include the subsidiary as part of its consolidated group, but the Department did not permit Taxpayer to include that subsidiary, claiming that the subsidiary did not have nexus with Indiana. Finally, Taxpayer protests the imposition of a ten percent (10%) penalty for negligence.

I. Adjusted Gross Income Tax— Eligibility for inclusion in a consolidated return.

DISCUSSION

First, Taxpayer argues that the non-insurance subsidiaries and the life insurance company should be permitted to file consolidated returns for all tax types. In particular, Taxpayer argues that its calculations of adjusted gross income and supplemental net income tax should permit the full benefit of the two groups combined income (or losses) and their combined adjusted gross income.

Under Ind. Code § 6-3-4-14:

> (a) An affiliated group of corporations shall have the privilege of making a consolidated return with respect to the taxes imposed by IC 6-3. The making of a consolidated return shall be upon the condition that all corporations which at any time during the taxable year have been members of the affiliated group consent to all of the provisions of this section including all provisions of the consolidated return regulations prescribed pursuant to Section 1502 of the Internal Revenue Code and incorporated herein by reference and all regulations promulgated by the department implementing this section prior to the last day prescribed by law for the filing of such return. The making of a consolidated return shall be considered as such consent. In

> the case of a corporation which is a member of the affiliated group for a fractional part of the year, the consolidated return shall include the income of such corporation for such part of the year as it is a member of the affiliated group.
> (b) For the purposes of this section the term "affiliated group" shall mean an "affiliated group" as defined in Section 1504 of the Internal Revenue Code with the exception that the affiliated group shall not include any corporation which does not have adjusted gross income derived from sources within the state of Indiana.
> (c) For purposes of IC 6-3-1-3.5(b), the determination of "taxable income," as defined in Section 63 of the Internal Revenue Code, of any affiliated group of corporations making a consolidated return and of each corporation in the group, both during and after the period of affiliation, shall be determined pursuant to the regulations prescribed under Section 1502 of the Internal Revenue Code.
> (d) Any credit against the taxes imposed by IC 6-3 which is available to any corporation which is a member of an affiliated group of corporations making a consolidated return shall be applied against the tax liability of the affiliated group.

Taxpayer argues that the life insurance company does, for purposes of this section, have Indiana adjusted gross income, even though the adjusted gross income of the life insurance company is not subject to tax.

At the onset of this discussion, Taxpayer and the Department appear to agree on at least one piece of methodology. First, the gross income tax of both the non-insurance subsidiaries and the life insurance company are computed in the normal manner. Second, the non-insurance subsidiaries, on a consolidated basis and under the provisions of Ind. Code § 6-3-2-2, and the life insurance companY under Ind. Code § 6-3-8-2(c)(2), would compute their apportionment factors, and apply the respective apportionment factors to their respective incomes to arrive at adjusted gross income (or in the case of the life insurance company, a *pro forma* adjusted gross income).

At this point, however, the calculations begin to differ. First, the gross income tax becomes a credit against adjusted gross income tax. Ind. Code § 6-3-3-2. Taxpayer seeks to use the combined gross income tax against the adjusted gross income tax of just the non-insurance subsidiaries due to the exemption from adjusted gross income tax for domestic insurance companies. Ind. Code § 6-3-2-2.8(4). However, the Department sought to allow the gross income tax of only the non-insurance subsidiaries as a credit against the adjusted gross income tax of those same entities, with the gross income tax of the life insurance company standing alone.

A further difference occurs in the supplemental net income tax. Under the supplemental net income tax provisions, a taxpayer’s adjusted gross income tax is figured under the normal apportionment/allocation method provided under Ind. Code § 6-3-2-2, except in the case of domestic insurance companies. In the case of domestic insurance companies, the adjusted gross income is apportioned on a single-factor basis, namely premiums at risk. Ind. Code § 6-3-8-2(b)-(c).

For most corporations, a deduction is allowable for the highest of a taxpayer's adjusted gross income tax, gross income tax, or gross premiums tax. In the case of a domestic life insurance company, a deduction is allowable for the higher of the gross income tax or gross premiums tax. *Id.*

Here, it is difficult to reconcile Taxpayer's position that the income of the entities should be consolidated for either tax type. First, with respect to adjusted gross income tax, the life insurance company is exempt. Period. Accordingly, the life insurance company's income situation does not affect the adjusted gross income for the non-insurance subsidiaries.

Further, with respect to the credit against adjusted gross income tax, Taxpayer seeks a "best of both worlds" situation. Taxpayer is seeking to compute its adjusted gross income tax without the inclusion of an entity-namely, the life insurance company. Then, once it gets done with that, it seeks to use that same entity to claim a credit against the tax for all other entities. In short, Taxpayer is using an artificially high figure for gross income tax to offset a lowered adjusted gross income tax.

Taxpayer argues that it is in fact eligible to use the credit for gross income taxes owed by the life insurance company in order to offset the adjusted gross income tax owed by the non-life insurance subsidiaries. Taxpayer argues that Ind. Code § 6-3-4-14 permits corporations that file consolidated federal income tax returns and that have adjusted gross income from Indiana sources to file consolidated adjusted gross income tax returns. Taxpayer asserts that the insurance companies have adjusted gross income from Indiana sources, but merely do not pay tax on that.

Taxpayer further cites to *Associated Insurance Co. v. Indiana Dep't of State Revenue*, 655 N.E.2d 1271 (Ind. Tax 1995). In that particular case, the taxpayer consisted of a group of insurance companies that filed a consolidated gross income tax return. Several members of the group were eligible for a credit based on providing health insurance to individuals who could not otherwise obtain private health insurance. *Id.* at 1272. Various members of the group accrued credits greater than those members' gross income tax liabilities, as computed on a separate-company basis. The taxpayer sought to use the credit against the overall gross income tax liability of the consolidated group, rather than limit the credit to the liabilities of the separate members that incurred eligible expenses. The court held that the credits were allowable to offset the entire liability. *Id.* at 1276.

Here, Taxpayer's situation is distinctly different. Unlike the insurance companies in *Associated Insurance* that sought to apply a credit for a tax for which all members of the group were liable, Taxpayer here is seeking to use a credit to reduce its consolidated tax liability while not being subject to the very liability that it is seeking to reduce.

Further, within the overall structure of Indiana's tax code, Taxpayer's argument fails. When read together, the effect is that corporate taxpayers pay the higher of their adjusted gross income tax liability or gross income tax liability. This implies that the taxpayers are subject to both liabilities. While this is certainly true of the non-insurance subsidiaries, the life insurance company is not subject to both taxes; it is only subject to gross income tax, and then only if it

elects to be so treated to be subject in lieu of the gross premiums tax under Ind. Code § 27-1-18-2. Accordingly, based on the overall structure of the tax codes, the only logical result is that non-insurance subsidiaries must be segregated from the life insurance company.

Finally, even if Taxpayer does qualify for inclusion of the insurance company in its consolidated return, the issue of whether the return fairly reflects Taxpayer's Indiana source income must be addressed. Under Ind. Code § 6-3-2-2(l),

> If the allocation and apportionment provisions of this article do not fairly reflect the taxpayer's income derived from sources within the state of Indiana, the taxpayer may petition for or the department may require, in respect to all or any part of the taxpayer's business activity, if reasonable:
>
> (1) separate accounting
> (2) the exclusion of any one (1) or more of the factors;
> (3) the inclusion of one(1) or more additional factors which will fairly represent the taxpayer's income derived from sources within the state of Indiana; or
> (4) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income

Here, Taxpayer is seeking to effectively eliminate its adjusted gross income tax liability by use of a credit from an entity that is not even subject to the tax. To achieve a more equitable allocation of the income that Taxpayer provided, separate accounting between the life insurance company and the non-life insurance subsidiaries was a method to fairly reflect the income of each part of its business. Accordingly, Taxpayer's protest is denied on this basis.

With respect to the supplemental net income tax, Taxpayer's argument fails again. First, the very statute that prescribes the method by which the tax is computed, Ind. Code § 6-3-8-2, gives a method (one-factor apportionment) for domestic life insurance companies and a separate method (apportionment and allocation per Ind. Code § 6-3-2-2) for other corporations subject to the tax. This implies that the Legislature did not intend for the two types of businesses to be combined. Accordingly, the audit was correct in computing Taxpayer's supplemental net income tax separately for the life insurance company and the non-life insurance subsidiaries.

FINDING

Taxpayer's protest is denied.

II. Adjusted Gross Income Tax-Computation of research expense credit

DISCUSSION

Taxpayer argues that the auditor computed Taxpayer's credit for research expenses incorrectly. Under Ind. Code § 6-3.1-4-2, as it existed for the years in question, the statute provided in relevant part:

(b) A taxpayer who does not have income apportioned to this state for a taxable year under IC 6-3-2-2 is entitled to a research expense tax credit for the taxable year in the amount of the product of:
(1) five percent, multiplied by
(2) the remainder of the taxpayer's Indiana qualified research expenses for the taxable year, minus:
(A) the taxpayer's base period Indiana qualified research expenses, for taxable years beginning before January 1, 1990
(B) the taxpayer's base amount, for taxable years beginning after December 31, 1989

(c) A taxpayer who has income apportioned to this state for a taxable year under IC 6-3-2-2 is entitled to a research expense tax credit for the taxable year in the amount of the lesser of:
(1) the amount determined under subsection (b); or
(2) five percent multiplied by the remainder of the taxpayer's total qualified research expenses for the taxable year, minus:
(A) the taxpayer's base period research expenses, for taxable years beginning before January 1, 1990
(B) the taxpayer's base amount, for taxable years beginning after December 31, 1989
further multiplied by the percentage determined under IC 6-3-2-2 for the apportionment of the taxpayer's income for the taxable year to this state.

Taxpayer sought to compute the amount of the credit based on the apportionment factors of each subsidiary that had qualifying research expenditures, rather than the apportionment factor for the entire consolidated group.

In order to do this, first Taxpayer found the amount of the increase in research expenses for each subsidiary. Then, Taxpayer prorated its expenses to each entity based on its increase. This gave each entity's share of research expenses. Then, the apportionment factor for each entity was applied to the entity's share of research expenses. This provided the amount that Taxpayer sought to use for paragraph (c) of the statutory calculation.

For instance, for one year the computation, using Taxpayer's methods as amended and Taxpayer's apportionment factor for the entire consolidated group was as follows:

Line		Indiana only qualified research	Total federal qualified research
4	Wages for qualified services	$14,177,632.00	$15,074,064.00
5	Cost of supplies	$5,123,701.00	$5,488,669.00
6	Rental or lease cost of computers		$0.00
7	65% of contract expenses	$4,323,696.00	$4,982,551.00
8	Total qualified research expenses	$23,625,029.00	$25,545,284.00
9	Fixed base percentage	0.01	0.01

10	Average annual gross receipts	$1,227,165,003.00	$1,227,165,003.00
11	Multiply line 10 by line 9	$12,271,650.03	$12,271,650.03
12	Subtract line 11 from line 8	$11,353,378.97	$13,273,633.97
13	Multiply line 8 by 50%	$11,812,514.50	$12,772,642.00
14	Enter the smaller of line 12 or line 13	$11,353,378.97	$12,772,642.00
15	Add lines 3 (not relevant for this taxpayer) and 14	$11,353,378.97	$12,772,642.00
16	Enter Indiana apportionment percentage for the current year		0.2039
17	Multiply line 15 column B by the percentage on line 16		$9,315,483.41
18	Enter the smaller of amount on line 15 column A, or line 17		$9,315,483.41
19	Allowable percentage for Indiana research expense tax credit		0.05
20	Multiply line 18 by 5%, enter amount of current year tentative credit		$465,774.17

However, Taxpayer, in computing the amount of the allowable credit, sought to do the following (a minor discrepancy exists between the calculations of the expenses eligible for computation):

Company	Qualifying expenditures	Amount for computation
A	$289,422.00	$12,768,207.00
B	$2,728,572.00	$12,768,207.00
C	$20,667,730.00	$12,768,207.00
D	$1,621,962.00	$12,768,207.00
E	$228,726.00	$12,768,207.00
Total	$25,536,412.00	

Company	Credit allocation %	Pre-apportionment QRE	Apportionment percentage	Post-apportionment QRE
A	1.13%	$144,711.01	0%	$0.00
B	10.69%	$1,364,286.11	16.88%	$230,291.49
C	80.93%	$10,333,865.81	86.81%	$8,970,828.91
D	6.35%	$810,981.06	0	$0.00
E	0.90%	$114,363.01	100%	$114,363.01
Total				$9,315,483.41

Thus, Taxpayer sought to use $9,315,483 as its qualified expenses in place $2,603,437 ($12,768,207*20.39%) based on the Department’s apportionment formula.

Taxpayer argues that its computation is consistent with Ind. Code § 6-3.1-4-4, which provides:

> The provision of Section 41 of the Internal Revenue Code and the regulations promulgated in respect to those provisions are applicable to the interpretation and administration by the department of the credit provided by this chapter, including the allocation and pass through of the credit to various taxpayers and the transitional rules for determination of the base period.

Section 41(f) of the Internal Revenue Code provides that, where a group of corporations are part of a controlled group, the credit for research activities shall be aggregated and then divided up proportionately among the corporations based on their individual research expenses and payments. For these purposes, a "controlled group" is defined differently than an affiliated group for consolidated corporate income tax returns. Whereas I.R.C. § 1501 et seq. require eighty percent control of the relevant corporations by the same persons to be part of a consolidated income tax return, I.R.C § 41(f)(5) only requires fifty percent control of the relevant corporations.

As a result of the different control provisions and the reference in Indiana's statutes to "taxpayer", Taxpayer argues that the intent of the provision requires computation of the credit on a separate corporation basis.

Basically, there are two methods for computing adjusted gross income tax in a consolidated group. The strongly preferred method is the combined approach. Under this approach, a consolidated group's income is to be figured on the basis of the whole consolidated group. That is, the net income for the various corporations and the apportionment factors are to be computed as if all the corporations were one large entity. This contrasts with the "stacked" method, in which each corporation's income and apportionment factors are determined separately, then the corporations respective income are added together to arrive at a total for the entire group.

In this instance, Taxpayer's argument is valid to the extent that the various ultimate taxpayers are separate entities for tax purposes. For instance, if the credit had to be distributed among several corporations that filed separately, or among partners in a partnership, then Taxpayer's method would be applicable.

Here, however, Taxpayer seeks the benefit of yet another "best of both worlds" approach. Basically, Taxpayer is attempting to seek the full benefit of the normal method in determining its income, while seeking the full benefit of the stacked method when seeking the tax credit for research expenses. Consistently throughout the income tax provisions, "taxpayer" in a consolidated group refers to the group, not the individual corporations that constitute the consolidated group. Accordingly, to the extent the corporations that constitute the consolidated group are eligible for expenses, Taxpayer is required to determine the credit for the group in the aggregate, then determine the portion allowable for credit using the aggregated apportionment factors for the consolidated group, not those of the individual members.

Further, even if Taxpayer's method is to be accepted, Taxpayer is required to determine the credit consistently for each entity. Here, Taxpayer sought to apply the calculation under

subsection (b) in the aggregate, while the subsection (c) calculation was determined separately. Accordingly, even if Taxpayer's method of computing the credit on a stacked basis is accepted, Taxpayer has not provided sufficient information to demonstrate that its method was correct for computing the credit under subsection (b).

Taxpayer has further raised a constitutional challenge to Indiana's credit regime, charging that it potentially discriminates against multistate businesses. The Department is not an appropriate forum to make such decisions, and accordingly this argument is denied.

FINDING

Taxpayer's protest is denied.

III. Adjusted Gross Income Tax--Inclusion of subsidiary in a consolidated return.

DISCUSSION

Taxpayer also protests the auditor's disallowance of one subsidiary in its consolidated filing. Initially, Taxpayer had not included the subsidiary in its consolidated return. However, when the Department audited the file, Taxpayer sought to include the subsidiary in its consolidated group. Taxpayer has not provided sufficient information to permit the Department to conclude that the auditor was incorrect, and accordingly is denied.

FINDING

Taxpayer's protest is denied.

VII. Tax Administration--Penalty

DISCUSSION

Taxpayer argues that it is not subject to negligence penalties with respect to the additional taxes assessed against it. In particular, Taxpayer argues that the additional tax was due to its different, but reasonable, interpretation of the statute. Accordingly, it argues that it was not negligent in its tax returns for the years in question.

Penalty waiver is permitted if the taxpayer shows that the failure to pay the full amount of the tax was due to reasonable cause and not due to willful neglect. Ind. Code § 6-8.1-10-2.1. The Indiana Administrative Code further provides:

> (b) "Negligence" on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules

and/or regulations is treated as negligence. Further, failure to read and follow instructions provided by the department is treated as negligence. Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer.

(c) The department shall waive the negligence penalty imposed under IC 6-8.1-10-1 if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust, or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section. Factors which may be considered in determining reasonable cause include, but are not limited to:

(1) the nature of the tax involved;

(2) judicial precedents set by Indiana courts;

(3) judicial precedents established in jurisdictions outside Indiana;

(4) published department instructions, information bulletins, letters of findings, rulings, letters of advice, etc.;

(5) previous audits or letters of findings concerning the issue and taxpayer involved in the penalty assessment.

Reasonable cause is a fact sensitive question and thus will be dealt with according to the particular facts and circumstances of each case.

45 IAC 15-11-2.

Taxpayer has made the requisite showing per statute and regulation, and accordingly is sustained.

FINDING

Taxpayer's protest is sustained.

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